No. 12073

In the United States
Circuit Court of Appeals
for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Appellant,

v.

ROSS B. HAMMOND,
Appellee.

On Appeal from the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANT

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Assistant Attorney General.
ELLIS N. SLACK,
A. F. PRESCOTT,
EDWARD J. P. ZIMMERMAN,
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INDEX

CITATIONS

Page

Cases:

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OPINION BELOW

The opinion of the District Court (R. 19-39) is reported in 80 F. Supp. 212.

JURISDICTION

This appeal involves federal income taxes for the taxable year 1943. The taxes in dispute were paid as follows: $157,146.90 on August 17, 1945. (R. 21.) Claim for refund was filed on August 22, 1945 (R. 21), and the Commissioner did not within six months either allow or reject the claim. (R. 21). Within the time provided in Section 3772 of the Internal Revenue Code and on March 16, 1946, the taxpayer brought an action in the District Court for recovery of the taxes paid. (R. 2-4.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1340. The judgment was entered on April 21, 1948. (R. 40-41.) Within sixty days and on June 18, 1948, a notice of appeal was filed. (R. 41-42.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the method of accounting employed by the Commissioner in determining deficiency in income tax was authorized under Section 41 of the Internal Revenue Code.

This in turn depends upon a determination of whether taxpayer received from the Commissioner permission to report income on the accrual basis, whether in fact the accrual method was employed, and whether taxpayer's accounting basis "does not clearly reflect the income" within the meaning of Section 41 of the Code.

2. Whether the setting aside of large sums in accordance with profit-sharing agreements with two employees, whereby the excess of certain amounts was to remain in the company, was an allowable deduction as business expense under Section 23 (a) (1) and therefore properly accrued in the taxable year 1943.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are to be found in the Appendix, *infra.*

STATEMENT

The facts herein, substantially as found by the District Court, and insofar as material to the issues on appeal, may be summarized as follows:

Taxpayer is an individual, resident of Oregon. On July 27, 1945, the Commissioner assessed against taxpayer a deficiency in income and surtaxes for the taxable year 1943,

in the sum of $145,537.77, together with interest of $11,-609.13, totalling $157,146.90. Taxpayer paid in cash $150,-592.88 of this, the remainder being paid by credit allowed for refund on an overassessment for 1941. (R. 20-21.)

On August 22, 1945, taxpayer filed a claim for refund of the additional taxes paid, and subsequent to six months thereafter filed suit in the United States District Court for the District of Oregon, the Commissioner not having approved nor rejected the claim. (R. 21.)

The deficiency in income and surtaxes was based upon the report of Revenue Agent, W. G. Williams (R. 21, 596), in part upon the refusal of the Commissioner to recognize a partnership between taxpayer and his son[1] and in part upon the Commissioner's rejection of the partnership accounting method. (R. 21-22.)

Prior to the tax year 1938, taxpayer conducted his contracting business in the name of a corporation which kept its books on the percentage of completion basis. Taxpayer kept his individual accounts on the cash basis. As of the end of the year 1938, the corporation was dissolved, and until the formation of the partnership between father and son, taxpayer conducted the business in his own name. When the corporation was dissolved, it had been engaged in constructing the State Capitol Building at Salem, Oregon. Upon dissolution, taxpayer individually completed

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1 This determination is not in issue upon this appeal.

the project. In 1937, the corporation had reported the income from the project on the percentage of completion basis. (R. 25.)

The court below found that taxpayer applied to the Commissioner for permission to adopt individually the accrual basis of accounting, with the exception that income to be reported from the state capitol project was to be reported on the percentage of completion basis. The court also found that in 1938 the Commissioner granted such permission, and that taxpayer thereafter maintained his accounts and reported his income in the manner so permitted.[2] The court also found that in all years subsequent to 1938 the father and son partnership maintained the accrual method of accounting, making no change in method. The court found that the accounts clearly reflected the income of the partnership. (R. 26-27.)

The court found that income in the tax years in question was properly reported and deductions properly taken, and found that there was no basis either in fact or law for the rejection of taxpayer's method of accounting and that the method of accounting employed by the Commissioner to reflect the income of the partnership was an improper method of accounting because based partly on an accrual, partly

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2 The court found that taxpayer reported on the accrual basis in and after 1938, but that in 1938 he reported the remainder of the State Capitol Building project on the percentage-of-completion basis. (R. 26.)

upon a percentage of profit, and in part upon a completion of contract basis. (R. 27.)

The Commissioner disputes the findings set out in the two preceding paragraphs.

In addition to what may be termed the "accounting issue," there is in issue a profit sharing agreement between taxpayer and two of his employees. The taxpayer on February 3, 1942, entered into such an agreement with one Henry M. Mason. (R. 28.)

Under the agreement, Mason was to be paid 20% of the profits of the company for each calendar year, after deduction of expenses but before deduction of income taxes. The parties agreed that the business needed large working capital and agreed that Mason's compensation was to be paid by a drawing account of $500 per month, but that Mason was not to be permitted to draw more than $10,000 in any one year. Funds in excess of that amount were to be permitted to remain in the company, for use as working capital, bearing no interest. The agreement provided for cancellation, and provided that if Mason left the company and desired to withdraw his earnings, one year's notice of demand for such funds must be given taxpayer. If Mason should cancel the agreement or resign, the drawing account of $500 monthly was to be his entire compensation for that calendar year. Were the drawing account to exceed 20% of the profits, it was to be charged against any amounts

accrued to Mason's account under the agreement. The final paragraph of the agreement was an agreement that the contract was one of employment only, that Mason received thereby no interest in the business, all payments to represent compensation for services rendered. (R. 28-32.) Taxpayer entered into an agreement on the same date with one A. V. Peterson, providing similarly, but providing for a $400 monthly drawing account, with a maximum annual withdrawal of $7,500 yearly. (R. 32.)

In the tax year 1942, the share of profits earned by Peterson and Mason in accordance with the terms of the contracts with taxpayer amounted to $86,635.88; in the tax year 1943, $77,366.37. These amounts were computed upon the same accounting method used to compute taxpayer's profits, and credited against Mason's and Peterson's accounts. (R. 32-33.)

The court below found that the profits accrued to Mason and Peterson, but paid subsequently to 1942-1943, were proper deductions in the tax years as expenses in taxpayer's return. (R. 33.)

The court also found that when the revenue agent examined taxpayer's books, resulting in the report noted, *supra,* he had knowledge of all the facts pertaining to deductions under the profit-sharing agreements and that he examined into their propriety but did not disallow or reject such deductions, nor did the Commissioner reject the

deductions as a basis for assessment of deficiency. (R. 33-34.)

The action for refund was commenced on March 16, 1946. On July 19, 1946, the Collector interposed his answer, but did not set up any counterclaim, set-off, or defense based upon the Mason-Peterson deductions. But on October 18, 1947, the Collector moved for leave to file an amended answer in which it was claimed for the first time that the Mason-Peterson deductions should not have been allowed. Taxpayer objected on the ground that no cause was shown why such matters should not have been referred to at an earlier date, that there was no showing of due diligence, that the amendment set out a new cause of action, and that the set-off termed "Additional Defense" was barred by the statute of limiations contained in the Internal Revenue Code. The court denied the Collector's motion upon the grounds urged. (R. 18-19, 34-35.)

But upon trial of the action, the court permitted evidence upon the Mason-Peterson deduction issue, subject to taxpayer's objections. Thereafter, the court found that taxpayer's objections were well taken and also found upon the merits that the share of profits credited on taxpayer's books and by the partnership to Mason and Peterson and accrued as expense and deductions were properly taken. (R. 35.)

The court below found that the deficiency assessed and

collected was illegal and granted judgment for taxpayer, April 21, 1948. (R. 36, 40.)

The court also granted a judgment dismissing the Collector's suit for $6,554.03, which had been consolidated with the action at bar. This action had been brought for the refund credit allowed for 1941, noted *supra,* with which taxpayer had paid part of the deficiency assessed for 1943. Taxpayer therefore was adjudged entitled to recover but $150,592.88, plus interest thereon. (R. 36-37.)

The court's conclusions of law are set out at R. 37-39.

The Collector filed his notice of appeal June 15, 1948. (R. 41.) Taxpayer moved to dismiss the appeal on the ground that the Collector failed to file the transcript for docketing in this Court within the time provided by Rule 73(g) of the Federal Rules of Civil Procedure. This Court denied the motion. *Maloney* v. *Hammond,* 171 F. 2d 225.

STATEMENT OF POINTS TO BE URGED

1. The District Court erred in finding and concluding that taxpayer's method of accounting clearly reflected taxable income.

2. The District Court erred in finding and concluding that taxpayer was entitled to deduct a percentage of his profits from the partnership under profit-sharing agreements with two of his employees.

3. The District Court erred in denying Collector's motion to amend his answer and plead as a set-off that taxpayer had not overpaid his taxes on the grounds that he failed to include in his taxable income for the period involved all of his income from the partnership.

4. The District Court erred in finding and concluding that the Commissioner of Internal Revenue authorized taxpayer to file his federal income tax returns on the accrual basis of accounting and in not concluding that the Commissioner of Internal Revenue authorized taxpayer to report his long-term contracts on the percentage of completion basis.

5. The District Court erred in not finding and concluding that taxpayer maintained stock piles of material which were not reflected in reporting net income from long-term contracts.

SUMMARY OF ARGUMENT

Taxpayer's method of accounting distorts his income. He did not follow the method authorized by the Commissioner, accrual coupled with the reporting of long-term contracts on a percentage of completion basis. The attempted accrual method used by taxpayer did not clearly reflect his income and the Commissioner therefore properly exercised his broad discretion to recompute taxpayer's income in order

that it might clearly reflect income. Such determination should stand in the absence of taxpayer's showing that his method does clearly reflect income. Taxpayer failed to follow the Regulations applicable to percentage of completion accounting in that he failed to keep inventories and failed to accrue uncompleted work. Accordingly, the Commissioner's method of accounting, being the best available under the circumstances to clearly reflect taxpayer's income year by year, should be allowed to stand, taxpayer not having sustained his burden of proving overpayment of tax.

Taxpayer did not properly accrue deductions for amounts set aside to be paid Mason and Peterson under their profit-sharing agreements. The amounts so credited were not constructively received, nor were they fixed and definite obligations, for there was no certainty that any amounts credited might ever be paid over. Moreover, assuming *arguendo* that the amounts might properly be accrued, the amounts credited could not be deducted until paid under the provisions of the Internal Revenue Code providing for contributions of an employer under a deferred payment plan. The problem of the Mason-Peterson deductions is a proper subject of appeal, in that the District Court abused its discretion in denying Collector's motion to amend his answer to present the question and in that the District Court necessarily had to reach the merits to decide whether or not taxpayer had overpaid his tax.

ARGUMENT

I

The District Court Erred in Accepting Taxpayer's Method of Accounting and Rejecting Commissioner's.

Under Section 42 of the Internal Revenue Code (Appendix, *infra*), taxpayer is bound to account annually or on a fiscal year basis for all his income. This he may do by one of several methods—accrual, cash receipts and expenditures, or on a long-term basis, as provided in Treasury Regulations 94, Article 42-4 (Appendix, *infra*).[3]

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3 Subsequent Regulations deal with the same subject matter, and, for the purposes of the case at bar are the same. Treasury Regulations 111, Section 29.42-4; Treasury Regulations 103, Section 19.42-4; Treasury Regulations 101, Article 42-4. Article 42-4 provides in part that as to long-term contracts:

> (*a*) Gross income derived from such contracts may be reported upon the basis of percentage of completion. * * * There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return. * * *
>
> * * * *

(Footnote 3 continued)

A taxpayer may change his method of accounting to accord with paragraph (*a*) or (*b*) of this article only after permission is secured from the Commissioner as provided in article 41-2.

Article 41-2 and corresponding subsequent Regulations require the permission of the Commissioner whenever a taxpayer's accounting method is changed.

The taxpayer contended below that he adopted the accrual method of accounting, in accordance with permission granted by the Commissioner, upon dissolution of his corporation, and that his method of accounting fairly and clearly reflected his income for the taxable years involved. The District Court so found.

It is the Collector's position that the findings of the court below permit taxpayer to utilize a system of accounting which distorts his income and inhibits an orderly collection of income tax.

We contend that the taxpayer, in following the method he used, did not use the system he requested and received permission to use from the Commissioner, except in the first year to which the permission applied. Taxpayer actually received permission to use an accrual basis coupled with permission to report long-term contracts on a percentage-of-completion basis. He did not follow the method so permitted. Even assuming *arguendo* that taxpayer had the right to use the accrual system alone and used it, such a method did not clearly reflect taxpayer's income. As a

result, the Commissioner, as he is authorized to do, adopted his own determination as to the accounting method to be followed for taxpayer's income for the taxable years involved. We contend that the court erred in rejecting this method of the Commissioner's. In this connection we point out that Section 41 of the Internal Revenue Code (Appendix, *infra*) provides:

> * * * if the method employed [by the taxpayer] does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

The problem of which was the proper method of accounting necessarily depends upon the facts of each case, and must be resolved by an examination of the record.

During the years involved taxpayer, and subsequently taxpayer and his son as partners, entered into several long-term contracts. These were of varying types, depending upon the terms of compensation—fixed fee, lump-sum, or cost-plus basis (R. 149.) There was also one characterized by taxpayer as "entirely different." (R. 149, *et seq.*) All the contract accounts were kept on an attempted accrual basis. In substance, taxpayer accrued all labor and material as acquired. As the work progressed on these contracts, taxpayer or someone on his staff periodically estimated the work that had been done, and submitted the estimates to

the owners' engineers or architects for approval. Thereafter, the owners were billed. (R. 155-159; 232-235.) An effort was made to collect as much as possible as the work progressed. (R. 162, 176, 233, 405.) Generally, when materials were received and delivered to the project, the owners were billed therefor. (R. 234-235, 245-246, 338-340.) Billings for materials were not delayed until the materials were incorporated in the construction. On some contracts, materials not incorporated into the project could not be billed while merely stored on the job. (R. 246.) Yet no inventories of materials on hand were maintained in any case. (R. 169, 177, 181-182, 245, 247, 309-310.) Frequently, materials on hand in December would not enter into billings made until the subsequent year, nor would work done, if no estimate were made before the end of the year, as was frequently the case. (R. 310-315, 318-319.) Yet expenses would be accrued for this period, expenses for materials being accrued upon receipt thereof. (R. 249, 319.)

Under the fixed-fee and cost-plus contracts, 90% of the fixed fee was billed and paid as it accrued, in monthly installments based on estimates of percentage of completion. The balance was paid upon completion and final architectural or engineering acceptance. Monthly payments, up to 90% of the contract price, were made under lump-sum contracts for labor and materials put into the work and 75% of all staple materials stored at the site, up to the first

day of the month as estimated by the architect-engineer. The remainder was paid upon final certificate.

The revenue agent making his investigation determined that subsequent to 1938, taxpayer had not kept his books and reported income on a percentage-of-completion basis, but had instead used an "attempted accrual basis." (R. 600.) And accordingly proper accruals were not entered in the contract accounts in the books, income not being properly accrued, nor cost of materials set up as a prepaid expense. He felt that the distortion of income present in the years under consideration was primarily due to failure to keep inventories of materials on hand but not yet incorporated in the construction work being done. (R. 442, 462.) An inventory would have been required under Article 42-4 of Treasury Regulations 94, had taxpayer properly reported on the percentage-of-completion basis. He found a marked distortion of income and determined that to recompute the income for the years in question in accordance with a true percentage-of-completion method, or in accordance with a true accrual basis, would entail a prohibitive amount of time. Accordingly, he attempted to devise a retrospective method of accounting which would fairly reflect the income of the years under examination. To do this he applied the ratio of profit to total income received on each contract to the yearly income received in each case. His recomputation rests upon such basis.

Admittedly, the method the revenue agent employed is not one explicitly provided for by the Regulations, nor by the Internal Revenue Code. But it does narrow the distortion of profits reported in the several years under the method employed by taxpayer. The Commissioner has broad discretion in making a recomputation clearly to reflect income, which may be reviewed only when abuse is shown. *William Hardy, Inc.* v. *Commissioner*, 82 F. 2d 249 (C. A. 2d), citing *Brown* v. *Helvering*, 291 U. S. 193, and *Lucas* v. *American Code Co.*, 280 U. S. 445; *In re Newman*, 94 F. 2d 108 (C. A. 6th). *Carver* v. *Commissioner*, 10 T. C. 171, appeal pending (C. A. 6th). The Commissioner is not bound by stereotyped methods of accounting, but he must have some leeway in determining, as he is bound to do, whether income is properly reflected. *William Hardy, Inc.* v. *Commissioner*, *supra.* Therein the court also states that the Commissioner's acceptance of returns on the basis he seeks to change is not binding upon him. Accord, *Carver* v. *Commissioner*, *supra.* And in the absence of a showing by the taxpayer that taxpayer's method accurately reflects income for the years in question, it would seem that the Commissioner's method should be sustained. Taxpayer failed to make such a showing.

Taxpayer principally took the position that he was properly returning income on the accrual basis, and that thereunder it was unnecessary for him to take into account ma-

terials on hand and not yet used. The court found that the Commissioner had authorized taxpayer to report income on the accrual basis, but we contend on the contrary that the Commissioner authorized him to report on accrual, with long-term contracts reported on the percentage of completion basis. This would not be inconsistent permission, nor would it produce a "hybrid" system of accounting.

The taxpayer first wrote to the Commissioner requesting (R. 633), "In accordance with requirements of Article 42-4, Regulations 94," that he be permitted to change his accounting basis. Prior to that time, the corporation had been reporting on accrual plus percentage-of-completion basis. In the letter, taxpayer stated that the corporation had been dissolved and the business transferred to him as a sole proprietorship. The purpose of the letter was stated to be an attempt to take every precaution to see (R. 633-634)—

> that the method heretofore employed by the corporation is perpetuated and that the new ownership is permitted to file upon the same basis as that used by the corporation.

The letter states in addition that in view of the fact that the corporation's books had been kept on an accrual basis, the individual books would be kept on a similar basis, and returns accordingly made on an accrual basis.

Taxpayer's attorney attempted to explain away the request for permission to report on a percentage-of-completion

basis on the ground that the letter was written by a layman. But taxpayer testified below that "very probably it was dictated" by his counsel. (R. 203.) This would be consistent with taxpayer's admitted ignorance of accounting bases and tax regulations. (R. 160-161, 202.) Since taxpayer thought the corporation was on a "finished basis,"[4] (R. 161), it is hardly likely he would write a letter clearly identifying and indicating knowledge of the percentage-of-completion basis and applicable Regulations.

The Commissioner, in answer, advised taxpayer that (R. 635)—

> to the extent that your income is derived from long-term contracts, as defined in article 42-4 of Regulations 94, you may report your gross income from such contracts upon either of the two bases set forth in that article * * *.

Replying to the Commissioner's letter, taxpayer stated (R. 636):

> I requested permission to report income from contracts, as an individual, on a *percentage-of-completion* basis, as the corporation had previously been doing, and to keep all accounts and make all returns on an accrual basis. Your reply of March 29th, grants permission to me to report income from contracts as the

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4 This, despite the fact that it was admittedly on the percentage-of-completion basis. The court also found as much. (R. 25.)

> corporation had been doing, but makes no statement regarding keeping all accounts on an accrual basis. (Emphasis supplied.)

He then stated that the corporation had been keeping its books and filing its returns on an accrual basis while he personally had been on the cash basis, that the corporation had been dissolved, that all future returns would be made as an individual, and that since his main income was from the construction business (R. 637)—

> which has been kept on an accrual basis, we, therefore, request definite permission to make all future returns of Ross B. Hammond as an individual on the same basis as the corporation had previously made returns, which is the accrual basis.

After requesting further information, the Commissioner wrote taxpayer granting permission to report his income on the accrual instead of the cash basis, beginning with the tax year ending December 31, 1938. (R. 518-519.) As the court below found, taxpayer in and after 1938 reported his income on the accrual basis, with the exception that the tag end of the State Capitol Building contract in 1938 was reported on the percentage-of-completion basis.[5] (R. 26.)

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5 It is not unworthy of note that the first letter of the Commissioner discussed in the text (R. 634-635), points out to taxpayer that whatever method is first followed must thereafter be followed unless subsequent permission to change is granted by the Commissioner.

The only logical interpretation to be put on this correspondence is that taxpayer wanted to change from the cash to the accrual basis, but still wanted to report long-term contracts as the corporation had been doing prior to dissolution, on the percentage-of-completion basis. His actions in 1938 bear this conclusion out. His reports in subsequent years do not, but it is unnecessary that they do, in view of the accounting method employed for the return for 1938. The District Court's conclusion that the Commissioner authorized straight accrual accounting seems clearly erroneous therefore and should be reversed.

Accordingly, under Article 42-4 of Regulations 94, taxpayer should have kept an inventory of stock-piles over the years in question, which he did not. Further, in accordance with that article, if—

> it is found that the taxable net income * * * has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

For "the method employed by the taxpayer is never conclusive." *Brown* v. *Helvering, supra* (p. 203).

When the revenue agent investigated, he found that taxpayer purportedly kept his books on an accrual basis, but that actually this basis was a hybrid, neither a true accrual basis nor a true percentage-of-completion basis. No inventories had been made; no consideration was given to work which had not been completed but was in progress

at the end of the year, nor to equipment or material which had been accrued on the books but not used. Article 42-4 and subsequent Regulations dealing with the same subject specifically require such accounting practices.

It would seem, moreover, that inventory of stock piles and accruing of uncompleted work are vital to clear reflection of income on long-term contracts.[6] If stock piles and unbilled work are not accrued or taken account of, it is clear that a taxpayer may readily throw income into the year which is not profitable to him. Or, if as taxpayer proceeded here, materials are accrued as expense when delivered to the job, expense may be incurred in years of high income by way of materials procured for a subsequent year's operation. Such a distortion would seem to be indicated by taxpayer's Troutdale project.[7]

The revenue agent did not change the figures of in-

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6 It was admitted at trial that in any construction project there was a considerable amount of work at the end of the year which could not be billed and would therefore not be accrued under taxpayer's method of accounting. (R. 176-177; 310-315; 318-319.) On some jobs admittedly there was a stock pile. (R. 176-177.)

7 In 1941 taxpayer reported gross income of $59,000 and showed a profit of nearly $24,000. The next year showed a loss of over $20,000 against a gross income of over $1,000,000. The third year profit was $94,000, gross nearly $275,000. Other projects showed a similar, though lesser, distortion. (R. 612-618.)

come shown on taxpayer's books and returns. He merely shifted the income to a given year in accordance with the percentage of which the contracts had been completed in that year. This corresponds with the requirement of Sections 41 and 42 of the Internal Revenue Code, which clearly contemplate clear reflection of income for each taxable period rather than the eventual reporting of all income received. Cf. *Security Mills Co.* v. *Commissioner,* 321 U. S. 281. The fact that true income may eventually be returned is irrelevant, and a dangerous consideration if tax rates fluctuate. The Commissioner is therefore empowered, in reaccounting a taxpayer's income clearly to reflect income, to seek a clear representation for each year involved.

The Commissioner's method is not explicitly set forth in the Code or in the Regulations. But taxpayer is not entitled to recover upon the mere showing that an unprescribed method has been used by the Commissioner in recomputing the tax. His is the burden to show that he has overpaid his tax. *Lewis* v. *Reynolds,* 284 U. S. 281, 599.[8] It might be suggested that the Commissioner's method is inferior to taxpayer's in that every so often, a recomputation must be made. This criticism is invalid. As the revenue agent indicated, the Commissioner's recomputation does not repre

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8 In this connection, the discussion *supra,* of the Commissioner's broad discretion in the method to be used in recomputation is pertinent.

sent a permanent basis of accounting. (R. 601.) The method used was used because it was too late, the time requirement too great, to recompute taxpayer's income on a true accrual or a true percentage-of-completion basis. It was the best method available, and should therefore be upheld.

II

The District Court Erred in Finding that Amounts Set Aside Under the Mason-Peterson Profit-Sharing Agreements Were Properly Accrued Deductions in the Taxable Year.

Under their contracts with taxpayer neither Mason nor Peterson had an unrestricted right to demand payment of the amounts credited to their accounts. There is no question but that they did not constructively receive income in the taxable year as a result of their accounts being credited by taxpayer. Nor did either of them report as income the amounts so credited and sought by taxpayer to be accrued.

The problem of whether taxpayer properly accrued and therefore properly deducted the amounts set aside over and above the monthly drawing accounts and yearly maxima provided in the contracts depends upon whether the amounts were properly accrued within the meaning of Section 43 of the Internal Revenue Code. (Appendix, *infra.*) See also, Treasury Regulations 111, Section 29.43-1. The cases apropos to the problem turn on the question of whether

the compensation sought to be deducted is contingent or definite, or, in other words, whether taxpayer's liability to his employees is so conditioned as to make payment or amount uncertain. *Willoughby Camera Stores* v. *Commissioner,* 125 F. 2d 607 (C.A. 2d); *Commissioner* v. *Brooklyn R. S. Corp.,* 79 F. 2d 833 (C.A. 2d); *S. Naitove & Co.* v. *Commissioner,* 32 F. 2d 949 (C.A. D.C.); *Field & Start, Inc.* v. *Commissioner,* 17 B.T.A. 1206, affirmed, 44 F. 2d 1014 (C.A. 2d), certiorari denied, 283 U. S. 826. Compare *Kaufman Department Stores* v. *Commissioner,* 34 F. 2d 257 (C.A. 3d.)

It is clear from the agreements that Mason's and Peterson's deferred compensation, the amounts plowed back into the business, were not definite obligations of taxpayer. They were in fact contingent. Although each year, sums certain might be accrued to the credit of the two employees, these sums were subject always to being cut down when their percentages of the profits failed to match the amounts they were entitled to draw. As opposed to the *Kaufman Stores* case, the cutting down was not contingent upon there being losses, but merely upon net profits falling below a certain amount. Furthermore, even though either employee could cancel his agreement with taxpayer, the cancellation could not effect a withdrawal of amounts accrued to the employee's credit except subject to a year's notice, which gave the contingency full opportunity to operate to his dis-

advantage. Fundamentally, the employee's additional compensation was faced with two contingencies—his remaining in the business and the continued success of the business. In such circumstances, it would certainly seem improper to allow deductions by way of accrual for the amounts set aside, even though in the particular case the contingencies never destroyed the credit balances held for the two employees.

Even assuming, for the sake of argument, that the sums set aside for Mason and Peterson were properly accruable, Section 23 (p) (1) (D) of the Internal Revenue Code (Appendix, *infra*) would bar the deduction. Although Section 23(p) is headed "Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan," even where payment of compensation is deferred only as to a portion of taxpayer's employees, the section would seem to apply.

Section 23 (p) (1) provides that "if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation", it shall be deductible only in the year in which paid, if the plan is not included in paragraphs (A), (B), or (C) of the section. These set out plans and limitations upon percentages of profits which can be set aside. It would seem a fair conclusion that any other agreement deferring the receipt of compensation is covered by paragraph (D). The legislative

history of the section bears out such a conclusion. See S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 140-141 (1942-2 Cum. Bull. 504, 609).

Section 23 (p)(1) provides moreover for the absence of a plan, wherein it states:

> If there is no plan but a method of employer contributions or compensation has the effect of a * * * profit-sharing * * * or similar plan deferring the receipt of compensation, this paragraph shall apply as if there were such a plan.

It is clear that the agreements with Mason and Peterson have "the effect" of a profit-sharing plan, although they do not extend to all of taxpayer's employees. Accordingly, deductions for payments thereunder are not properly accrued until there is payment of the amounts sought to be deducted, under paragraph (D) of the section.

The District Court refused to permit the Collector to amend his answer to set up affirmatively the question of the deductibility of the amounts set aside for Peterson and Mason. The court's decision rests in this respect in its sound discretion under Rule 15(a) of the Federal Rules of Civil Procedure. The rule, however, provides that leave to amend is freely to be given when justice so requires. The word "freely" was used advisedly to obviate technicalities. 1 Moore's Federal Practice, Section 15.06, p. 806. Either party, moreover, is privileged to amend. *McDowall* v. *Orr*

Felt & Blanket Co., 146 F. 2d 136 (C.A. 6th); *Hall* v. *Gordon*, 128 F. 2d 461 (C.A. D.C.); *Frank Adam Electric Co.* v. *Westinghouse Elec. Mfg. Co.*, 146 F. 2d 165 (C.A. 8th). It is our position that the court abused its discretion in denying Collector's motion to amend which would fairly have presented the issues involved to the court.

One reason the court gave for its action was the bar of the statute of limitations. This reasoning is erroneous, for where "no new assessment can be made, after the bar of the statute has fallen, the taxpayer, nevertheless, is not entitled to a refund unless he has overpaid his tax." *Lewis* v. *Reynolds, supra,* p. 283. As the Supreme Court has said further, in *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 361:

> But the presumption is that taxes paid are rightly collected upon assessments correctly made by the Commissioner, and in a suit to recover them the burden rests upon the taxpayer to prove all the facts necessary to establish the illegality of the collection.

The burden is not upon the Commissioner to show present ability to collect the deficiency assessed.

Irrespective, moreover, of whether or not the court below abused its discretion in denying Collector's motion to amend, it was required to pass upon the merits of the Mason-Peterson deductions, in order to determine whether, on the authority of *Lewis* v. *Reynolds, supra,* taxpayer had over-

paid his tax. Not only did the court have to pass upon the merits but in denying a motion to amend which would have presented those merits the court abused its discretion.

CONCLUSION

The decision of the District Court that taxpayer should recover his payment of deficiency assessed for 1943 was erroneous and should be reversed.

Respectfully submitted,

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April, 1949

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 162 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(p) *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.*—

(1) *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent:

* * * * *

(D) In the taxable year when paid, if the plan is not one included in paragraphs (A), (B), or (C), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

* * * * *

If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, this paragraph shall apply as if there were such a plan.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23)

SEC. 41. GENERAL RULES.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1946 ed., Sec. 41)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such

amounts are to be properly accounted for as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 42)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 43)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 42-4.[9] *Long-term contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term "long-term contracts" means building, installation, or construction

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9 Subsequent Regulations dealing with the same subject are the same in so far as they deal with the case at bar. Treasury Regulations 111, promulgated under the Internal Revenue Code, Sec. 29.42-4; Treasury Regulations 103, promulgated under the Internal Revenue Code, Sec. 19.42-4; Treasury Regulations 101, promulgated under the Revenue Act of 1938, Art. 42-4.

contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this article only after permission is secured from the Commissioner as provided in article 41-2.